Articles

Intricate Ingredients: Counsel's Recipe for Commercial Mortgage-Backed Securities,

Charles Marshall
Texas Lawyer
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Charlie Marshall, a partner in the Dallas office of Andrews & Kurth, specializes in the origination of mortgage loans for securitization.

With the issuance in 1998 of more than $78 billion of commercial mortgage-backed securities (CMBS)—a dramatic increase from $8 billion in 1991—Wall Street has given commercial real estate access to a larger pool of capital than ever before. This increased role of the capital markets has also dramatically altered the role of real estate counsel.

Mortgage loans traditionally have been closed the same way my West Texas grandmother baked: She labored alone in her kitchen, cooked without recipes, measured ingredients by hand, seasoned by taste and smell, and served her day's work only to her family, whose simple tastes she knew well.

Today the CMBS kitchen is filled with lots of cooks, including originators, loan purchasers, issuers, rating agencies, investors, trustees and master and special loan servicers with voracious, yet delicate appetites. And each insists that specific and intricate ingredients be used in a precise recipe by real estate closing counsel. Using a recipe laden with such exotic ingredients as "basis points," "defeasance," "tranches" and "bankruptcy remote," real estate counsel must satisfy the legal and economic requirements and accommodate the appetites of multiple parties.

In a commercial mortgage-backed securitization, large numbers of mortgage loans are pooled to create a diverse collection of revenue-producing assets that support the issuance of marketable securities. A national rating agency evaluates the investment risks and divides the pool into separate classes of securities. The CMBS issuer, typically an affiliate of an investment bank, accumulates the commercial real estate loans pursuant to mortgage loan purchase agreements with loan originators.

The issuer must describe the loans in a prospectus and must ensure that the statements made in the prospectus about the loans and the investment risks are not materially misleading to a reasonable investor. Investors in securitization transactions, while sophisticated in investing generally, may lack the ability or expertise to examine mortgage loan and real estate assets, which require appraisal and servicing.

CMBS cooks rely on representations and warranties regarding the mortgage loans and the underlying real estate assets made by the loan originator. The representations and warranties are based on the investment-grade recipe used by rating agencies in providing an investment rating for each class of securities. Compliance with the representations and warranties and other investment profiles reduces the investment risk and permits the rating agency to grant higher ratings. A high rating lowers the interest rate that must be paid, resulting in greater economic benefit to borrowers, originators and issuers.

The Ingredients

Typical representations and warranties made by loan originators in mortgage loan purchase agreements include the following ingredients:

- The mortgage securing the loan creates a valid and enforceable first priority lien on the mortgaged property except for typical exceptions, which do not materially interfere with the security or the ability of the property to generate income sufficient to service the loan;
- All improvements on the property lay within the boundaries and building restriction lines except for encroachments that are either insured against by the lender's title insurance policy or that do not materially and adversely affect the value or marketability of the properties;

- An environmental site assessment was performed that either reveals no violations of environmental laws or, if any such violations exist, states that funds have been escrowed to remediate such violations;
- The loan documents are valid and enforceable obligations of the borrower;
- There are no delinquent or unpaid taxes and assessments and each mortgaged property constitutes a separate tax parcel;
- The improvements located on the mortgaged property comply with applicable zoning and other ordinances or constitute a legally nonconforming use or structure;
- There are no pending or threatened legal proceedings against or affecting a borrower or the related mortgaged property that may materially or adversely affect the value of the property or the ability of the borrower to pay debt service on the loan;
- Any subordinate debt is subject to a subordination and standstill agreement that subordinates the loan and prohibits the related junior creditor from pursuing any remedies or causing any bankruptcy proceeding while the loan is outstanding; and
- The borrower possesses all material licenses, permits and authorizations required for the ownership and operation of the property.

Additional representations and warranties address ground leases and specific economic terms of CMBS loans, such as defeasance and hyperamortization.

The recipe provided by the CMBS representations and warranties requires a heightened level of due diligence and strict monitoring of the closing process by real estate counsel. Any exceptions to the representations and warranties must, with the assistance of securitization lawyers, be disclosed. Since exceptions may adversely affect investment rating or the price an investor is willing to pay, closing counsel is pressured to structure the transaction and resolve issues to eliminate any exceptions.

Traditional mortgage lenders can forgive flaws in asset quality because the lender can look to the credit of the borrower. Since CMBS loans are typically non-recourse, however, asset quality is more important than the credit of the borrower. Because most CMBS loans are secured by older properties for which property compliance with zoning and other laws is usually difficult to establish conclusively, real estate counsel on CMBS loans plays a more involved role in identifying non-conformities and resolving issues with curative documents, title endorsements and insurance products such as "law or ordinance" and environmental risk coverage.

Traditional mortgage loans, originated and underwritten to fit a lender's own portfolio, can permit great flexibility in negotiating loan terms and loan documents. CMBS loans, however, are originated with the intent to be sold to third parties, and are viewed not as individual transactions but as part of an aggregate loan pool intended to create predictable cash flow for investors. The mortgage loan assets are expected to look similar in financial terms and in documentation. Real estate counsel must ensure conformity of critical loan document provisions such as prepayment, monetary grace periods, defeasance, restrictions on transfers, additional debt and single purpose entity covenants, and advise their clients on the consequences on loan pricing of changes to such provisions.

Real estate counsel on CMBS loans also plays a larger role in the structuring of the borrowing entity. To prevent the bankruptcy of a borrower from subjecting the real estate collateral to claims of the borrower's creditors, closing counsel must ensure that the borrower complies with single purpose bankruptcy remote requirements. Such requirements, reflected in both loan documents and entity documents, prohibit the borrower from engaging in any other business, acquiring other assets, incurring additional debt, merging or consolidating with other entities or dissolving or winding up its business, and require that the borrower adopt certain "separateness" covenants addressing such actions as keeping assets, books and records separate from other entities, following appropriate organizational formalities and holding itself out as a separate legal entity.

Larger loans typically require that the borrower also appoint an independent director whose vote will be required before the borrower can take certain actions, including filing a bankruptcy petition.

Tax statutes and regulations present additional important considerations. Mortgage pools are set up as real estate mortgage investment conduits, or REMICs, to avoid certain federal taxes. Since a REMIC is required to be a fixed pool of mortgage loans, any modification of a loan is restricted. Closing counsel must ensure that the loans comply with strict REMIC rules that require each loan to be fully disbursed at closing and prohibit any release of collateral or any change in the collateral with the lender’s consent except within narrow guidelines.

Knowledge of capital market requirements will not be limited to counsel representing CMBS originators. To preserve a CMBS exit strategy, traditional lenders will increasingly require that their real estate loans be "securitization friendly."

With the dominating role of the capital markets in real estate comes increasing exposure to a vo

latile global market as the real estate industry experienced in the fall of 1998. Something as far removed from U.S. real estate as Russian bond defaults can cause investors to demand a wider investment return for CMBS at all rating levels relative to Treasury yields. As a result, originators and borrowers of CMBS loans learned that "plain vanilla" is the favorite ingredient of rating agencies and investors. Real estate counsel will be expected to meet the demands for plain vanilla transactions by adhering to documentation and due diligence recipes.

The ruthless efficiency and competitiveness of the capital markets combined with the reduced legal fee expectations from our not-so-distant RTC experience provide additional pressures on closing counsel. In the view of Wall Street, closing a real estate loan has been converted into a science: "We've given you the recipe; how hard can it be?"

With the increasing complexity and accountability created by the CMBS process, closing counsel will be compelled to be more efficient, disciplined and even multidisciplinary, in providing legal services. The cozy loan-closing kitchen has become a demanding, mechanized bakery.